Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:CTM:LN:POSTF-125433-02
JMMarr

date: MAY 31 2002

to: Examination Division, LMSB [redacted] HMT (Laguna Niguel)
Attention: [redacted], Team Coordinator
[redacted], Revenue Agent

from: June Y. Bass, Associate Area Counsel, LMSB
Joyce M. Marr, Attorney JMM

subject: [redacted], Inc. and Subsidiaries
EIN: [redacted]
Tax Years under Audit: [redacted] - [redacted], inclusive
Application of IRC § 280C(b) to controlled group

This memorandum responds to your request for assistance dated May 6, 2002. This memorandum should not be cited as precedent.

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

ISSUES

1. Whether [redacted], Inc. (the Taxpayer) and its wholly-owned [redacted] controlled foreign corporation are members of a "controlled group of corporations" for purposes of I.R.C. § 280C(b)?

2. Whether the Taxpayer is required to reduce its deductions claimed for qualified clinical testing expenses pursuant to I.R.C. § 280C(b) by the amount allowable as a credit for such expenses under I.R.C. § 45C?

CONCLUSIONS

1. The Taxpayer and its wholly-owned [redacted] controlled foreign corporation are members of a "controlled group of corporations" for purposes of I.R.C. § 280C(b).

2. Yes, the Taxpayer is required to reduce its deductions claimed for qualified clinical testing expenses pursuant to I.R.C. § 280C(b) by the amount allowable as a credit for such expenses under I.R.C. § 45C.

FACTS[1]

The Taxpayer develops and commercializes specialty pharmaceutical products for the [redacted], [redacted], [redacted] and other [redacted] markets, as well as [redacted] surgical devices and [redacted]. For the years [redacted] through [redacted] inclusive, the Taxpayer elected to claim credits under I.R.C. § 45C for qualified clinical testing expenses it incurred for certain drugs for rare diseases or conditions.

The Taxpayer has agreed that I.R.C. § 280C(b) requires that any deductions for qualified clinical testing expenses must be reduced by the amount allowable as a credit for such expenses under section 45C. However, the Taxpayer claims that it is not subject to the I.R.C. § 280C(b) adjustment, although it is entitled to the credits, for one of its product lines because it charged back the clinical testing expenses for this product to its wholly-owned CFC incorporated in [redacted] which created a "wash" and hence, it did not deduct the expenses. In fact, the [redacted] CFC did reimburse the Taxpayer for its qualified clinical testing expenses for this product line.

Exam requested a copy of the contract between the Taxpayer and the [redacted] CFC to determine who retains the results of the research and who is entitled to the research credit. The Taxpayer indicated that there is no contract.

The Service's position is that the charge back transaction did not result in a "wash" because the Taxpayer should have treated the reimbursements (i.e., "charge backs") received from the CFC as income and deducted the expenditures for clinical testing. Hence, the Service claims that the expenses are subject to I.R.C. § 280C(b).

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[1] The facts stated herein are based on the information Exam has provided. We have not undertaken any independent investigation of the facts of this case. If the facts stated herein are incorrect or incomplete in any material respect, you should not rely on the opinions set forth in this memorandum, and should contact our office immediately.

DISCUSSION

Subject to certain limitations, a so-called "orphan drug credit" may be claimed equal to 50 percent of the qualified clinical testing expenses for the taxable year. I.R.C. § 45C. (formerly codified at I.R.C. § 28). To the extent that any such expenses are funded by any grant, contract, or otherwise by another person, the expenses do not qualify for the credit. I.R.C. § 45C(b)(1)(C). The credit is not allowed for clinical testing conducted outside the United States unless the testing is conducted outside the United States because there is an insufficient testing population in the United States, and the testing is conducted by a United States person or by another person not related to the taxpayer to whom the designation under section 526 of the Federal Food, Drug, and Cosmetic Act applies. I.R.C. § 45C(d)(2)(A).

I.R.C. § 280C(b) requires that the taxpayer's deduction for qualified clinical testing expenses be reduced by the amount allowable as a credit for such expenses under section 45C. In the case of a corporation which is a member of a controlled group of corporations (within the meaning of section 41(f)(5)) or a trade or business which is treated as being under common control with other trades or businesses (within the meaning of section 41(f)(1)(b)), this section is applied under rules prescribed by the Secretary of the Treasury similar to the rules applicable under I.R.C. § 41(f)(1)(A) and (B). I.R.C. § 280C(b)(3).

I.R.C. § 41(f)(1)(A)(i) provides that for purposes of determining the amount of the research credit, all members of the same controlled group of corporations are to be treated as a single taxpayer. The proportionate share of research credit allowable to any member of the controlled group is equal to that member's proportionate share of the increase in qualified research expenses giving rise to the credit. I.R.C. § 41(f)(1)(A)(ii).

I.R.C. § 41(f)(5) provides, in part, that for purposes of the research credit, a "controlled group of corporations" has the same meaning given to such term by I.R.C. § 1563(a) of the Code, except that "more than 50 percent" shall be substituted for "at least 80 percent" each place it appears in I.R.C. § 1563(a)(1).

I.R.C. § 1563(a)(1) provides that a parent-subsidiary controlled group exists where one or more chains of corporations are connected through stock ownership with a common parent corporation if the stock ownership percentage requirements of the section are met.

I.R.C. § 1563(b) provides when a corporation is a "component member of a controlled group of corporations." I.R.C. § 1563(b)(2)(C) excludes foreign corporations subject to tax under I.R.C. § 881 from being treated as a component member of a controlled group of corporations.

For purposes of section 41(f)(5), the term "controlled group of corporations" means two or more corporations connected through stock ownership as described in section 1563(a). The term "component" member for purposes of section 1563(b) merely defines a particular type of member. A controlled group may include corporations that are component members and corporations that are excluded members (and therefore not component members). I.R.C. § 1563(a). A corporation may be a member of a controlled group for purposes of section 1563(a), but may not be a component member for purposes of section 1561. In the present case, the fact that the foreign subsidiary was not a "component" member of the controlled group of corporations under section 1563(b)(2)(C) does not prevent the foreign subsidiary from being a member of the controlled group under section 1563(a). Therefore, the Taxpayer and its wholly owned [redacted] CFC are considered to be members of a controlled group for purposes of section 41(f)(5) and thus, section 280C(b).

This conclusion is consistent with the language in section 41(f)(5). In defining controlled group, section 41(f)(5) refers to the meaning of controlled group under section 1563(a). Section 41(f)(5) does not refer to the component member provisions under section 1563(b). Therefore, section 41(f)(1)(A) and (f)(5) should be construed to apply to a controlled group that may include a foreign corporation, even though the foreign corporation may not be a component member.

Because the Taxpayer and its [redacted] CFC are to be treated as a single taxpayer, the fact that the [redacted] CFC reimburses the Taxpayer for its clinical testing expenses does not make the research funded research as described in I.R.C. § 45C(b)(1)(C).

Moreover, since the Taxpayer and its [redacted] CFC are treated as a single taxpayer, the fact that the [redacted] CFC reimbursed the Taxpayer does not eliminate the clinical testing expenses for which credits have been claimed. This is because the controlled group as a whole is still out-of-pocket the amount that was expended for qualified clinical testing. When the Taxpayer states that the reimbursement income it received should be treated as netted against these clinical testing expenses, resulting in a "wash" for purposes of section 280C(b), it is in error. Since the Taxpayer and the [redacted] CFC are treated as a single taxpayer for purposes of section 280C(b), the items that

would be properly netted, resulting in a "wash," are the amount that the [redacted] CFC paid to the Taxpayer and that the Taxpayer, in turn, received. That is, it is the funding between the members of the controlled group which would be properly disregarded. Accordingly, the qualified clinical testing expenses for which a credit is allowable under I.R.C. § 45C are subject to I.R.C. § 280C(b), although they were charged back to (i.e., reimbursed by) the Taxpayer's [redacted] CFC.

Our advice has been coordinated with the Office of Chief Counsel pursuant to the NSAR pre-review procedures. If you have any questions, please contact Joyce M. Marr at 949-360-2688.